

**DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 98-0120 RST
Sales/Use Taxes
For Tax Period: 1995**

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ISSUES

I. Sales/Use Tax — Protective Clothing and Safety Equipment

Authority: IC 6-2.5-5-3
45 IAC 2.2-5-8; 45 IAC 2.2-5-12

Taxpayer protests the assessment of use tax on its purchases of protective clothing and safety equipment.

II. Sales/Use Tax — Packaging Equipment and Supplies

Authority: IC 6-2.5-5-3
45 IAC 2.2-5-8(d)(1)
Indiana Department of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983)

Taxpayer protests the inclusion, in the sample calculated by Audit, of packaging supplies and equipment used in packaging pharmaceutical products.

III. Sales/Use Tax — Exhibit Displays

Authority: IC 6-2.5-3-2(a); IC 6-2.5-3-1(b)

Taxpayer protests the percentage of use tax assessed on its exhibit display tables.

STATEMENT OF FACTS

Taxpayer manufactures pharmaceutical products. Additionally, taxpayer engages in a variety of ancillary activities – from research and development to marketing and sales. For tax year 1995, Audit assessed use tax on a variety of taxpayer's items. Taxpayer protested these assessments. Consequently, an administrative hearing was held and the Department issued a Letter of Findings. As taxpayer was not sustained on all issues, taxpayer timely requested, and the Department granted, a rehearing.

I. Sales/Use Tax — Protective Clothing and Safety Equipment

DISCUSSION

Taxpayer protested Audit's assessment of use tax on some of the protective clothing and safety equipment that taxpayer provided to its employees.

As taxpayer explained in its original protest:

To ensure product integrity, the Taxpayer requires its employees working directly on the production line and in work-in-process testing labs to wear uniforms, hairnets, and beard covers. Employees must also wear shoe covers and safety glasses in clean rooms during the production process.

Taxpayer maintained that under IC 6-2.5-5-3, as property acquired for the direct use in the direct production of other tangible personal property, its protective clothing and safety equipment should be exempt from Indiana sales and use taxes. Taxpayer then directed the Department's attention to its own definition of "essential and integral to production" as set out in 45 IAC 2.2-5-8(c)(2):

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt.

* * *

(F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

Taxpayer argued that the protective clothing and safety equipment was purchased, and used, to prevent contamination of the product during the manufacturing process.

According to Audit, taxpayer's employees did not change into their company uniforms, or don other protective gear, until they arrived at work. Once at work, a properly attired employee could move, unrestricted, throughout the production facility. Additionally, Audit noted that the employees were not required to change uniforms when entering or leaving production areas and facilities during lunch breaks. From these observations, Audit concluded that taxpayer's provision of uniforms did not serve to prevent product contamination. Consequently, the clothing did not qualify for the safety clothing exemption.

In the original Letter of Findings, the Department agreed with Audit's position. While taxpayer may have supplied employee uniforms to prevent product contamination, the actual use of the uniforms was inconsistent with this intent. Consequently, the Department concluded the uniforms were not provided for an exempt purpose.

However, such logic did not serve to exclude hairnets, beard covers, and safety glasses from exempt treatment. Even if worn outside production areas and facilities, these items, arguably, are not worn to prevent contamination from outside sources. Therefore, in the context of taxpayer's production processes, the Department founds that these items were exempt safety equipment.

The initial Letter of Findings, consistent with the aforementioned logic, arrived at the following conclusions:

“To the extent the hairnets, beard covers, and safety glasses are used by taxpayer's employees while working in production activities, taxpayer's protest is sustained. As to the rest of the items, taxpayer's protest is denied.”

In its letter requesting a rehearing, taxpayer made the following observations:

In its [original] protest, [Taxpayer] listed (1) hair nets, (2) beard covers, (3) safety glasses, (4) coveralls, (5) shoe covers, (6) gloves, and (7) uniforms as protective clothing or equipment. In its Letter of Findings, the Department approved an exemption for hair nets, beard covers and safety glasses but not for the clothing items. With respect to the other clothing items, the Letter of Findings discusses only uniforms and ruled that they are not exempt because the employees are not required to change uniforms upon entering or leaving production areas and facilities during lunch breaks. *However, the Department has not addressed coveralls, shoe covers, and gloves, which are exempt under the same standards applied by the Department to hairnets, beard covers, and safety glasses.* (Emphasis added.)

The Department did fail to address in its original Letter of Findings the exempt status of taxpayer's coveralls, shoe covers, and gloves. In support of its position, taxpayer provided detailed information showing that its coveralls, shoe covers, and gloves *were worn only in production areas and were systematically discarded upon leaving those areas*. After reviewing this information, the Department now concludes that taxpayer's coveralls, shoe covers, and gloves were used "to prevent contamination of the product during production" – a manner consistent with the exemption provided by 45 IAC 2.2-5-8(c)(2)(F).

FINDING

Taxpayer's protest is sustained.

II. Sales/Use Tax — Packaging Equipment and Supplies

DISCUSSION

Taxpayer protests the assessment of use tax on supplies and equipment used in its packaging of pharmaceutical products.

Within taxpayer's Packaging Department, there exist several types of packaging lines – bottle lines, blister pack lines, a hand fill line, and a Jone Cartoner line. Each line performs the packaging function using its own methodology and specialized equipment. Audit proposed assessments on the equipment used in these activities.

The Indiana Supreme Court has interpreted IC 6-2.5-5-3, one of the industrial exemptions, as exempting equipment found to be essential and integral to taxpayer's integrated production process. *Indiana Department of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983). The scope of this integrated production process for pharmaceutical manufacturers is discussed in 45 IAC 2.2-5-8(d)(1):

The production of pharmaceutical items is accomplished by a process which begins with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. Equipment used to transport raw materials to the manufacturing plant is employed prior to the first operation or activity constituting part of the integrated production process and is taxable. Weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing steps, through packaging, qualify for exemption. Equipment which loads

packaged products from the packaging step of production into storage, or from storage into delivery vehicles, is subject to tax. (Emphasis added.)

Taxpayer's original protest was denied because absent from taxpayer's argument was any language describing the context of taxpayer's packaging activities. In other words, the Department was unable to determine whether the packaging process was part of taxpayer's manufacturing process, and thus exempt, or part of its nonexempt research and development operations.

In its request for rehearing, taxpayer provided additional information describing the context in which the packaging equipment was used. To wit:

Section 11 [of the original protest] contains a detailed description of [taxpayer's] bottling lines and blister pack lines. Both types of lines package [taxpayer's] pharmaceutical products into bottles (pills) or plastic packs (capsules) **for sale to its customers.** The two bottling lines...were integrated lines required to place [taxpayer's] products in a completed form **in which they could be sold to customers.** (Emphasis added.)

From taxpayer's brief narrative it appears that the bottling and packaging processes are part of taxpayer's manufacturing processes. Taxpayer is packaging marketable (in this case, saleable) products, not products that have yet to receive FDA approval and thus, are not marketable.

FINDING

Taxpayer's protest is sustained.

III. Sales/Use Tax — Exhibit Displays

DISCUSSION

Taxpayer protests the proposed assessment of use tax on ninety-six percent (96%) of the value of its tables used in product exhibit displays.

Use tax is imposed on the "storage, use, or consumption of tangible personal property in Indiana." IC 6-2.5-3-2(a). "Storage" is defined as the "keeping or retention of tangible personal property for any purpose except the subsequent use of that property *solely* outside Indiana." IC 6-2.5-3-1(b). (Emphasis added.)

Taxpayer purchased trade show tables for displaying promotional items. These tables, as well as promotional items, were expensed to Department XYZ. As most of the promotional items were used out-of-state, Audit calculated a taxable percentage from a representative sample. Both taxpayer and Audit agreed that the taxable percentage of Department XYZ items used in Indiana should be four percent (4%). Hence, items expensed to Department XYZ were assessed at four percent (4%) of their value. Audit, however, proposed to assess use tax on the exhibit display tables at one hundred percent (100%) of their value.

Taxpayer's argument focuses on Audit's apparent inconsistency in applying the mutually agreed upon taxable percentage – four percent – to the assessment of items expensed to Department XYZ. Taxpayer believes that the exhibit display tables should be assessed at four percent (4%) of their value. Alternately, taxpayer reasons that if the Department agrees with Audit's assessment of the exhibit display tables at one hundred percent (100%), the tables should be excluded from the sample population as an unrepresentative "exceptional" item. This solution would require Audit to revisit its sampling methodology to recalculate Department XYZ's taxable percentage.

After reviewing the items that were included in the sample population, the Department agrees with taxpayer that the exhibit display tables were properly included in the population sample. Consequently, the tables should be assessed at four percent (4%) of their value.

FINDING

Taxpayer's protest is sustained.